The Dodd-Frank Wall Street Reform and Consumer Protection Act: Title IX, Investor Protection

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Summary

Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) contains 10 subtitles and 113 separate sections amending federal securities laws intended to improve investor protection. The range of Title IX's provisions is very broad: some sections will bring significant changes to the securities business, while others are little more than technical clarifications of the Securities and Exchange Commission's (SEC's) authority. This report provides brief summaries of those provisions that create new SEC authority, that were controversial during the legislative process, or that appear likely to have far-reaching consequences.

Some of the most noteworthy sections of Title IX address issues viewed as central to the financial crisis that erupted in 2007. These include

- enhanced regulation of credit rating agencies, whose triple-A ratings of "toxic" mortgage-backed bonds set the stage for panic;
- more stringent regulation of asset-backed securities, including a "skin in the game" requirement that issuers of such securities retain some of the risk; and
- a number of provisions relating to executive compensation, including authority to prohibit pay structures that create inappropriate risk in financial institutions.

Another driving force behind Title IX was the Bernard Madoff Ponzi scheme, which repeated SEC examinations and investigations failed to detect. Many sections seek to improve the SEC's performance, including

- creation of an Investor Advocate and Investor Advisory Committee within the SEC;
- establishment of a whistleblower program to produce tips about securities fraud;
- various measures to improve SEC management, including a wide-ranging outside consultant study and various Government Accountability Office audits; and
- more budget flexibility and authorization for higher appropriations levels.

Another group of provisions addresses the rights of investors and shareholders:

- the SEC may impose a fiduciary duty on broker-dealers who give investment advice, similar to the duty that already applies to investment advisers;
- municipal financial advisors must register with the SEC, and a majority of the Municipal Securities Rulemaking Board must be independent of the industry; and
- new disclosures and shareholder votes relating to executive compensation and corporate performance and governance, including SEC authority to allow certain shareholders to nominate candidates for the board of directors.

Because of the diversity of these and other provisions, it is difficult to characterize the scope and thrust of Title IX in its entirety. Some observers, however, describe it as the most significant change to securities law since the enactment of the original federal statutes in the 1930s. This report provides a selective overview, and will not be updated.

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Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act deals with investor protection and securities regulation. Within that general rubric, the title contains a very broad range of provisions. Parts of Title IX address aspects of the securities markets that are commonly viewed as directly involved in the financial crisis, such as credit ratings and securitization. In developing the legislation, however, Congress also addressed issues not directly related to the financial crisis. In particular, the Madoff and Stanford Ponzi schemes, discovered in late 2008 and early 2009, raised questions about the quality of regulation by the Securities and Exchange Commission (SEC). As a result, numerous provisions in Title IX address the SEC's performance and resources. Other key provisions deal with the duty of care that investment industry professionals owe to their clients and mechanisms by which shareholders can exert more effective control over corporate management.

This report provides brief summaries of selected provisions in Title IX. It attempts to include those provisions that create new SEC authority, that were controversial during the legislative process, or that appear likely to have far-reaching consequences for the regulation of securities markets. Among the provisions omitted are sections making marginal enhancements to SEC authority in particular areas of securities law.[1] Numerous such provisions, which were generally included at the request of the SEC and appear to make incremental changes in law and regulation, are not included in the interest of flow and brevity.

Subtitle A: Increasing Investor Protection

The Investor Advocate and Investor Advisory Committee

Sections 911 and 915 of Dodd-Frank create two entities within the SEC: an Investor Advisory Committee (IAC) and an Office of the Investor Advocate (IA). Section 911 establishes a statutory mandate for the IAC, which was created by the SEC in 2009 using its existing authority. The IAC is to advise and consult with the SEC on (1) regulatory priorities of the Commission; (2) the regulation of securities products, trading strategies, and fee structures, and the effectiveness of disclosure; (3) initiatives to protect investors; and (4) initiatives to promote investor confidence and market integrity. Members of the IAC will include the Investor Advocate, a representative of state securities commissions, and a representative of the interests of senior citizens. In addition, the SEC will appoint between 10 and 20 individuals, including individuals representing the interests of individual equity and debt investors (including investors in mutual funds) and the interests of institutional investors (including the interests of pension funds and registered investment companies). IAC members must be knowledgeable about investment issues and decisions and have reputations of integrity. The SEC is not bound to follow the IAC's recommendations, but it must issue a public statement assessing such recommendations and stating whether it intends to implement them.

Section 915 creates a new Office of the Investor Advocate. The IA, who is appointed by and reports to the Chairman of the SEC, will assist retail investors in resolving significant problems investors may have with the SEC or with self-regulatory organizations (SROs); identify areas in which investors would benefit from changes in the rules of the SEC or the SROs; identify problems that investors have with financial service providers and investment products; analyze the potential impact on investors of proposed SEC and SRO regulations; and (to the extent

[1] For example, under Section 929T, where it was previously a violation of law to offer an investor a securities contract that waived investor rights contained in SEC regulations, it is now also a violation to offer a contract that waives rights guaranteed by the rules of a securities exchange or a national securities association.

practicable) propose to the SEC and to Congress any changes that may be appropriate to mitigate problems and to promote the interests of investors.

Section 919D creates an Ombudsman position in the Office of the Investor Advocate, to act as a liaison between the SEC and retail investors in resolving problems that retail investors may have with the SEC or SROs and to make recommendations regarding policies and procedures to encourage persons to present questions to the IA regarding compliance with the securities laws. The Ombudsman will be appointed by the IA.

Fiduciary Duty for Providers of Investment Advice

Both SEC-registered broker-dealers and investment advisers frequently give their customers advice regarding securities investments. Under federal securities law, however, the two classes of investment professionals are held to different standards as to the quality of advice they must provide. Investment advisers are under a fiduciary duty as defined in the Investment Advisers Act of 1940 and the associated jurisprudence. The essence of the fiduciary duty is that investment advice must be in the best interest of the customer. Broker-dealers, under the Securities Exchange Act of 1934, must meet a standard of suitability: their recommendations must not be unsuitable to the needs of a particular customer.

Since many securities firms employ both brokers and advisers—and many individuals are registered in both capacities—there is the possibility that customers may not understand the difference. When a customer is advised to buy a certain mutual fund, for example, is the advice influenced by the compensation that the seller receives? If the adviser is under a fiduciary duty, the answer should be no, even though the recommended fund may be a suitable investment for the customer.

Section 913 deals with the issue of a fiduciary duty that would apply to broker-dealers and investment advisers alike.[2] The House and Senate took different approaches: the House-passed version of H.R. 4173 directed the SEC to create a single fiduciary standard by regulation, while the Senate-passed version called for a study of the issue. The conference version adopted both approaches: the SEC is to study the fiduciary duty question and report to Congress within six months of enactment. At the same time the legislation gives the SEC authority to establish a uniform fiduciary duty by rule. The SEC is not required to issue such a rule.

Streamlined SRO Rule Approval

The SEC has the right of approval over all proposed rules of self-regulatory organizations (SROs) in the securities industry—the stock and options exchanges and (the Financial Industry Regulatory Authority (FINRA, formerly the National Association of Securities Dealers), which registers brokers and handles many customer complaints. Section 916 responds to industry concerns that the SEC has not always approved (or disapproved) proposed rules in a timely manner. The section sets timetables for SEC consideration of proposed SRO rules: generally, the SEC must act within 45 days, but extensions are possible, particularly for rule proposals that are lengthy or complex or raise novel regulatory issues.

[2] See CRS Report R41381, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Standards of Conduct of Brokers, Dealers, and Investment Advisers*, by Michael V. Seitzinger.

Financial Planners Study

Section 919C calls for a Government Accountability Office (GAO) study of the financial planning industry and the use of the "financial planner" designation. The study is to consider, among other things, the possible risk posed to investors and other consumers by individuals who otherwise use titles, designations, or marketing materials in a misleading way in connection with the delivery of financial advice; the ability of investors to understand licensing requirements and standards of care that apply to those who hold themselves out as financial planners; and the possible benefits of enhanced regulation and professional oversight of financial planners. The Senate Banking Committee considered provisions that would have created an SRO for individuals who called themselves financial planners, but the bill reported out of committee included the study, as did the version that passed the House.

Subtitle B: Increasing Regulatory Enforcement and Remedies

SEC Whistleblower Program

Section 922 seeks to create a robust whistleblower program within the SEC to encourage individuals with knowledge of securities fraud to come forward. The program is modeled on the Internal Revenue Service whistleblower program. A key element is the establishment of minimum awards—whistleblowers whose tips result in successful enforcement actions shall receive not less than 10% of the monetary sanctions collected in the action. SEC, SRO and other law enforcement personnel are not eligible, nor are auditors or persons convicted of criminal charges in the case where they brought forward information. The section also provides appeal rights in cases where the SEC decides not to make an award and confidentiality protections for whistleblowers.

Mandatory Arbitration of Securities Disputes

Section 921 addresses a controversial practice in securities markets—customers opening brokerage accounts often must agree to submit disputes to arbitration, waiving their right to take their broker to court.[3] Critics of mandatory arbitration characterize features of the process as unfair to investors. For example, the securities industry controls the pools of individuals from which arbitrators are selected, and customers bringing complaints are limited in their ability to compel brokerage firms to produce documents. On the other hand, defenders of arbitration point to cost savings that benefit investors and argue that the results of arbitration cases do not show any pro-industry bias.

The legislation amends the Securities Exchange Act of 1934 and the Investment Advisers Act of 1940 to authorize the SEC to issue rules that prohibit or restrict the use of agreements that require customers or clients of any broker, dealer, adviser, or municipal securities dealer to arbitrate any future dispute between them arising under federal securities law or regulation, or SRO rules, if the SEC finds that such action is in the public interest and for the protection of investors.

[3] For more information, see CRS Report RS22127, *Securities Arbitration: Background and Questions of Fairness*, by Gary Shorter.

Regulation D Offerings

Regulation D permits private offerings of securities, where issuers are not required to make the financial disclosures required of publicly traded companies. To qualify for Regulation D, issuers must abide by certain conditions and restrictions: generally, they may sell only to accredited investors,[4] they may not advertise their offerings to the general public, and there are restrictions on the resale of private securities. Under the SEC's Rule 506, issuers may sell an unlimited amount of securities without registering or filing reports with the SEC.[5]

Section 926 of Dodd-Frank prohibits "bad actors"—persons who have been convicted of violating securities law or been subject to certain enforcement actions by federal or state financial regulators—from issuing securities using the exemptions provided under Rule 506. (Similar prohibitions already applied to other forms of Regulation D offerings.)

Other Provisions

Subtitle B includes 35 separate sections, most of which provide enhancement or clarification of SEC enforcement authority or resources. These provisions include

- clarifying SEC authority over unlawful margin lending (Sec. 929);
- amendments to Fair Fund procedures, whereby defrauded investors may recover some of their losses (Sec. 929B);
- giving the SEC authority to serve subpoenas nationwide, regardless of where a particular case is filed (Sec. 929E);
- expanding the SEC's authority to punish aiders and abettors of securities fraud (Secs. 929M and 929N); and
- various amendments to the Securities Investor Protection Act (which reimburses investors when their brokers fail), including an increase in the minimum assessment paid into the insurance fund by broker-dealers and an increase in cash advances available to customers of failed brokerages from $100,000 to $250,000, which amount may be adjusted annually for inflation beginning 2011. (Secs. 929H and 929V.)

Subtitle C: Credit Rating Agencies

Credit rating agencies took a large share of the blame for the financial crisis. They assigned triple-A ratings to thousands of complex subprime mortgage-backed bonds that plunged in value when the housing boom stalled, triggering uncertainty about the true value of those securities and contributing to market-wide panic. Several distinct approaches to rating agency reform were considered:

- stricter regulation by the SEC, to ensure that conflicts of interest (e.g., between the rating and sales operations of the businesses) did not compromise the integrity or accuracy of ratings;

[4] "Accredited investors" must meet certain asset and income tests, which are modified by Section 413 of Dodd-Frank. They are presumed to be sophisticated investors, able to understand and bear investment risks, and thus less in need of government protection than general public investors.

[5] For a summary of the terms of Rule 506 offerings, see http://www.sec.gov/answers/rule506.htm.

- enhanced accountability through private litigation, by lowering the pleading standard for damage claims against rating agencies based on losses attributable to faulty ratings;
- reducing the significance of ratings in the securities marketplace by removing references to ratings in law and regulation, in order to remove any hint of government imprimatur; and
- increasing transparency, by requiring rating agencies to disclose information about their methods and models, and about the facts underlying the rating, to allow investors to perform independent evaluations of securities.

The first two approaches are somewhat at odds with the third—the first two implicitly assume that ratings will remain a critical tool for investment decisions and seek to improve their accuracy, while the third considers them inherently fallible, and views any implicit or explicit government endorsement of ratings as undermining market discipline. The fourth approach in a sense bridges the gaps between the others. In Dodd-Frank, Congress adopted all these approaches.

Enhanced Regulation and Accountability

Subtitle C includes provisions enhancing the SEC regulatory scheme for "nationally recognized statistical rating organizations" (NRSROs) that was created by the Credit Rating Agency Reform Act of 2006 (P.L. 109-291). Dodd-Frank follows the 2006 act in that it does not permit the SEC to regulate or evaluate rating methodologies or models, but it does seek to ensure that ratings are actually based on an objective application of those methodologies, and that commercial considerations do not influence rating decisions.

Section 932 creates an Office of Credit Ratings in the SEC, imposes more stringent conflict-of-interest regulation (for example, the act includes "revolving door" restrictions on rating agency employees who go to work for companies whose securities they rated), and gives rating agency compliance officers additional responsibilities, including an annual report to the SEC. Section 936 requires rating analysts to meet standards of training, experience, and competence necessary to produce accurate ratings, and to be tested for knowledge of the credit rating process.

Section 932 also requires NRSROs to have boards of directors with at least half the members independent of the NRSRO.

Section 939F addresses what many observers believe to be the central conflict of interest in the ratings business: the "issuer pays" model, where companies not only compensate the rating agency but also choose the agency that will perform the rating. Section 939F directs the SEC to study the issue and create by rule a mechanism whereby the selection of an NRSRO to rate an asset-backed security issue is made on a random or semi-random basis. The mechanism is to be that set out in Section 939D of the Senate-passed version of H.R. 4173 (the Franken amendment), unless the SEC determines that an alternative mechanism would better serve the public interest and protect investors. Under the Franken amendment, the SEC is to define a pool of "qualified" NRSROs, and establish a board to assign initial credit ratings for certain complex securities and to determine rating agency compensation for performing such ratings.

Section 933 increases legal liability by lowering the pleading standard in private lawsuits seeking money damages from a credit rating agency. Under the new standard, it shall be sufficient, for purposes of pleading any required state of mind in relation to such action, that the complaint state with particularity facts giving rise to a strong inference that the credit rating agency knowingly or recklessly failed (1) to conduct a reasonable investigation of the rated security with respect to the factual elements relied upon by its own methodology for evaluating credit risk; or (2) to obtain reasonable verification of such factual elements (which verification may be based on a sampling technique that does not amount to an audit) from other sources that the credit rating agency considered to be competent and that were independent of the issuer and underwriter of the security.

Section 933 also states that credit ratings are not to be considered "forward-looking statements" for the purposes of Section 21E of the Securities Exchange Act, which provides a safe harbor for certain corporate disclosures (such as estimates of future earnings) from private lawsuits alleging untrue statements of material fact.

De-emphasizing Ratings

Dodd-Frank also contains provisions intended to reduce market reliance on ratings. Section 939 repeals several statutory provisions that make reference to credit ratings—including, for example, the provision in the Federal Deposit Insurance Act that prohibits federally insured thrift institutions from holding bonds that are rated below-investment-grade by a nationally recognized statistical rating organization (NRSRO). As a substitute for ratings, the FDIC (and other federal agencies) are directed to establish their own standards of credit-worthiness.

In addition, Section 939A requires each federal agency to review its regulations, identify any references to credit ratings, and remove any reference to or requirement of reliance on credit ratings. In substitution, each agency is to establish standards of credit-worthiness that are appropriate for the purposes of the regulations. The intent of removing references to credit ratings from law and regulation is to eliminate any sense that ratings carry a government imprimatur, and to encourage investors to perform their own analyses.

Section 939B removes rating agencies' exemption from the SEC's fair disclosure rules (Regulation FD). This means that corporations can no longer provide the agencies rating their securities with proprietary, non-public financial information (a common practice in the past) unless such information is simultaneously made public. As a result, investors should no longer believe that ratings are based on information superior to what they themselves can obtain.

Section 939G nullifies Rule 436(g) under the Securities Act of 1933, which exempted NRSROs from certain liability when ratings are included in an SEC registration statement or a securities offering prospectus. In the absence of Rule 436(g), an issuer that includes a credit rating issued by an NRSRO in a registration statement would be required to obtain the consent of the rating agency. As a result, the rating agency would be subject to potential Securities Act liability for false or incomplete disclosure. Since NRSROs receive no benefit from the inclusion of ratings, it might be expected that they would refuse to consent and that ratings would appear less frequently in offering materials.

Transparency and Disclosure

Section 932 includes extensive disclosure requirements. Each NRSRO rating must be accompanied by a form (in paper or electronic form, at the SEC's discretion) that contains information that can be used by investors and other users of credit ratings to better understand ratings, including the assumptions underlying the credit rating procedures and methodologies, the data that were relied on to determine the credit rating, and any problems or limitations with those data. Specific disclosure requirements apply to ratings of asset-backed securities—rating agencies must provide data on the underlying assets, as well as (if applicable) how and with what frequency the agency uses servicer or remittance reports to conduct surveillance of the credit rating. The nature and results of any due diligence investigation of the facts underlying a rating must also be disclosed.

Section 938 deals with universal rating symbols and addresses concerns that rating symbols can mean different things in different classes of securities. For example, the probability of default for a municipal bond rated AA might be significantly lower than for a corporate bond with the same rating. Section 938 requires NRSROs to apply any symbol used in a manner that is consistent for all types of securities for which the symbol is used. The section does not, however, prohibit an NRSRO from using distinct sets of symbols to denote credit ratings for different types of securities.

Subtitle D: Improvements to the Asset-Backed Securitization Process

The asset securitization process, where home mortgages or other loans are sold by the original lenders, pooled, and resold to bond investors, produced the assets that came to be called "toxic" during the crisis. Losses in value accruing to mortgage-backed securities, together with uncertainty as to the true value of such securities, were a key factor in the freezing of interbank credit flows, as market participants came to doubt the credit-worthiness of banks and the reliability of balance sheets.

Subtitle D addresses the asset-backed securities (ABS) market by imposing new obligations on "securitizers"—issuers of an ABS, or persons who organize and initiate ABS transactions by selling or transferring assets to an issuer—and (in some cases) on "originators," those who, through an extension of credit or otherwise, create a financial asset that collateralizes an asset-backed security and sell that asset directly or indirectly to a securitizer.

Risk Retention or "Skin in the Game"

The basic approach of Subtitle D is to require securitizers to have "skin in the game," that is, to retain a material portion of the credit risk in any ABS that they sell. By aligning the interests of sellers and buyers of ABS, the intent is to create incentives such that securitizers will take more care in selecting assets of good quality and that they will be less likely to create securities of such complexity that valuation is difficult in normal times and impossible when markets are under stress.

Section 941 directs the SEC and the banking regulators (Fed, OCC, and FDIC) to write rules that require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. With regard to securitization of residential mortgages, the Secretary of HUD and the director of the Federal Housing Finance Agency (FHFA) will also participate in the rulemaking. The rules will address classes of securitized assets separately—individual risk retention requirements will be tailored to securitizations of home mortgages, commercial mortgages, commercial loans, auto loans, and any other asset class that the regulators deem appropriate.

Securitizers must retain at least 5% of the total credit risk, unless the securitized assets meet standards of low credit risk to be established by the regulators for each asset class. In such cases, the amount of risk retained may be below 5%. Regulators must further define "qualified residential mortgages," taking into consideration underwriting and product features that historical loan performance data indicate result in a lower risk of default. Securitizations where all assets are qualified residential mortgages will be exempt from risk retention requirements.

Risk retention requirements may be divided between securitizers and originators, but only if the SEC and banking regulators jointly consider (1) whether the assets sold to the securitizer have terms, conditions, and characteristics that reflect low credit risk; (2) whether the form or volume of transactions in securitization markets creates incentives for imprudent origination of the type of loan or asset to be sold to the securitizer; and (3) the potential impact of the risk retention obligations on the access of consumers and businesses to credit on reasonable terms.

Section 941 gives regulators broad authority to exempt any securitization from the risk retention rules, provided that such exemptions help ensure high quality underwriting standards, encourage appropriate risk management practices by the securitizers and originators, improve the access of consumers and businesses to credit on reasonable terms, or otherwise are in the public interest and protect investors. Several types of securitizers are automatically exempt: Farm Credit System institutions, municipal issuers, and securitizations of certain assets insured or guaranteed by the United States or an agency of the United States. For purposes of this section, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are not considered to be agencies of the United States, although the regulators may, at their discretion, exempt securities issued by those government-sponsored enterprises.

Section 941 authorizes the regulators to craft risk retention rules that are appropriate to second-degree securitizations, where the assets being pooled and securitized are themselves ABS. Such complex securities, known as collateralized debt obligations (CDOs), or “CDO-squared,” were among the instruments that lost the most value during the crisis. The exemption for qualified residential mortgages does not apply to second-degree securitizations.

Enhanced Disclosure

Section 942 directs the SEC to adopt regulations governing disclosure of information about the assets underlying any ABS. Such disclosures shall include asset-level or loan-level data, if such data are necessary for investors to independently perform due diligence, including data having unique identifiers relating to loan brokers or originators; the nature and extent of the compensation of the broker or originator of the assets backing the security; and the amount of risk retention by the originators and the securitizer of such assets. To the extent feasible, the disclosures should permit investors to compare the performance of different ABS. The SEC has authority to exempt any issuers from the disclosure requirements.

Representations and Warranties

Section 943 deals with representations and warranties, which are essentially promises by originators to securitizers that assets meet certain credit standards. When rating an ABS, NRSROs must describe the representations, warranties, and enforcement mechanisms available to investors in the particular security and how they differ from the representations, warranties, and enforcement mechanisms in similar ABS. With regard to problem loans in the asset pool, securitizers must disclose fulfilled and unfulfilled repurchase requests across all trusts aggregated by the securitizer, so that investors may identify asset originators with clear underwriting deficiencies.

Issuer Due Diligence

Section 945 directs the SEC to write rules that require issuers of ABS to perform a due diligence review of the underlying assets and to disclose the nature of that review.

Subtitle E: Accountability and Executive Compensation

Many analyses of the causes of the financial crisis assign a role to flawed compensation structures: when executives and traders receive much of their pay in the form of a bonus that reflects a single year's results, they may have an incentive to take long-term risks that boost short-term earnings. In most years, they profit, and when the rare loss comes, they keep their past bonuses. Subtitle E contains a number of provisions intended to align the incentives and interests of long-term shareholders and employees.

Say-on-Pay Vote

Section 951 gives shareholders a "say-on-pay" vote, to approve or disapprove the compensation of executives. The vote will occur every one, two, or three years, at the shareholders' option. Another shareholder resolution vote will involve "golden parachute" payments, or severance pay received by executives in the event of a merger or takeover. Neither resolution will be binding on the company or its board of directors.

Independent Compensation Committee

Section 952 requires each stock exchange to adopt listing standards that require all listed companies to have a compensation committee of the board made up entirely of directors who are independent of the company. The listing standards shall permit compensation committees to hire compensation consultants (after taking into consideration SEC rules regarding compensation consultant independence) and to hire outside legal counsel.

Pay Versus Performance

Section 953 requires companies to include in their annual proxy statements disclosures that permit shareholders to compare executive compensation actually paid to the financial performance of the issuer. The disclosures shall include a comparison of the compensation of the CEO with the median pay of all employees of the company.

Clawback of Erroneously Awarded Compensation

Section 954 requires the stock exchanges to adopt listing standards that require executives to repay erroneously awarded compensation under certain circumstances. If a company files an accounting restatement due to "material noncompliance" with any financial reporting requirement, the company will recover from any current or former executive officer who received incentive-based compensation (including stock options awarded as compensation) during the three-year period preceding the date on which the issuer is required to prepare the restatement, the difference between the amount that was actually paid and what would have been paid to the executive officer had the original financial statement been accurate.

Pay Structures that Encourage Inappropriate Risks

Section 956 gives regulators broad authority to deal with the types of incentive-based compensation structures that some observers identify as a cause of the crisis. The banking regulators (the Fed, OCC, FDIC, and NCUA), the FHFA, and the SEC are directed to jointly issue regulations or guidelines to require covered financial institutions to disclose information about compensation structures (not individual pay packages) sufficient to allow regulators to determine whether an institution's pay structure provides compensation, fees, or benefits that (1) are excessive, or (2) could lead to material financial loss to the covered financial institution. The regulators are directed to prohibit incentive-based compensation structures that encourage inappropriate risks by covered financial institutions.

A "covered financial institution," for purposes of Section 956, means

- a depository institution or depository institution holding company, as such terms are defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813);
- a broker-dealer registered with the SEC;
- an investment adviser, as such term is defined in section 202(a)(11) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(11));
- a credit union, as described in section 19(b)(1)(A)(iv) of the Federal Reserve Act;
- Fannie Mae or Freddie Mac; and
- any other financial institution that the appropriate federal regulators, jointly, by rule, determine should be treated as a covered financial institution for purposes of this section.

This section does not apply to financial institutions with less than $1 billion in assets.

Subtitle F: Improvements to the Management of the Securities and Exchange Commission

Subtitle F is in significant part a response to perceived failures at the SEC. The Bernard Madoff Ponzi scheme, which was investigated several times by the SEC but not detected, raised questions about the competence of some SEC employees and about managerial and organizational weaknesses. Specifically, some of the SEC staff assigned to inspect Madoff's firm were inexperienced and took Madoff's false assertions at face value. Others failed to take simple steps, such as making a phone call or sending a letter to verify accounts where Madoff claimed to hold customer securities, that would have brought the fraud to light much earlier. There was little or no communication between divisions of the SEC: in one case, a team of investigators did not realize that another SEC investigation of Madoff had recently concluded. SEC supervisors did not support the efforts of front-line staff, in some cases transferring them to other projects before their Madoff inspections had reached a conclusion.

Certification of Internal Supervisory Controls

Section 961, modeled after the Sarbanes-Oxley Act, requires the SEC to submit an annual report to Congress containing an assessment of the effectiveness of the Commission's internal supervisory controls and procedures applicable to SEC staff who perform examinations of registered entities, enforcement investigations, or reviews of corporate financial filings. The report shall include a certification, signed by the directors of the Division of Enforcement, the Division of Corporation Finance, and the Office of Compliance Inspections and Examinations, that the SEC has adequate internal supervisory controls to carry out its duties. In addition, at least once every three years, the GAO shall review the adequacy and effectiveness of the internal supervisory control structure, and furnish Congress with a summary of that review.

GAO Evaluation of Personnel Management

Section 962 mandates that the GAO submit to Congress every three years an evaluation of the effectiveness of personnel management at the SEC. The GAO shall consider

- the effectiveness of supervisors in using the skills, talents, and motivation of SEC employees;
- the criteria for promoting employees to supervisory positions;
- the fairness of the application of the promotion criteria;
- the competence of the professional staff of the Commission;
- the efficiency of communication between the units of the SEC regarding the work of the Commission and efforts to promote such communication;
- the turnover within subunits of the SEC, including the consideration of supervisors whose subordinates have an unusually high rate of turnover;
- whether there are excessive numbers of low-level, mid-level, or senior-level managers;
- any initiatives that increase the competence of the staff of the Commission;
- actions taken regarding employees who have failed to perform their duties and circumstances under which the SEC has issued to employees a notice of termination; and
- such other factors relating to the management of the SEC as the Comptroller General determines are appropriate.

Annual GAO Audit of SEC Financial Controls

Section 963 requires the GAO to submit annually to Congress a report that describes the responsibility of the management of the SEC for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and contains an assessment of the effectiveness of that internal control structure and the procedures for financial reporting of the SEC during the previous fiscal year.

GAO Review of SEC Oversight of National Securities Associations

Federal securities law provides for the existence of a national securities association to play a self-regulatory role in the securities industry, under the oversight of the SEC. The only national securities association now extant is FINRA. Section 964 requires GAO to submit to Congress every three years an evaluation of SEC oversight of national securities associations. The GAO shall consider the governance of such national securities associations; examinations carried out, including the expertise of the examiners; executive compensation practices; arbitration services; regulation of advertising; cooperation with state securities administrators by the national securities associations to promote investor protection; funding; and other matters.

SEC Compliance Examiners

SEC compliance examiners work in the Office of Compliance, Inspections, and Examinations (OCIE). Section 965 of Dodd-Frank requires that the SEC's Division of Trading and Markets (which regulates broker-dealers and securities exchanges) and Division of Investment Management (which oversees investment advisers and mutual funds) also employ compliance examiners. The intent of the provision is to ensure that SEC examiners have expertise regarding the business of the entity they are examining.

SEC Organizational Study and Reform

Section 967 calls for the SEC to hire an independent consultant of high caliber and with expertise in organizational restructuring and the operations of capital markets to examine the internal operations, structure, funding, and the need for comprehensive reform of the SEC, as well as the SEC's relationship with and the reliance on self-regulatory organizations and other entities relevant to the regulation of securities and the protection of securities investors that are under the SEC's oversight. Specific areas of study shall include

- possible elimination of unnecessary or redundant units at the SEC;
- improving communications between SEC offices and divisions;
- the need to put in place a clear chain-of-command structure, particularly for enforcement examinations and compliance inspections;
- the effect of high-frequency trading and other technological advances on the market and what the SEC requires to monitor the effect of such trading and advances on the market;
- the SEC's hiring authorities, workplace policies, and personal practices; and
- whether the SEC's oversight and reliance on self-regulatory organizations promotes efficient and effective governance for the securities markets.

Subtitle G: Strengthening Corporate Governance

Proxy Access

Shareholder groups have for many years sought legislation or regulations that allow shareholders to nominate candidates for a company's board of directors, and to have those candidates included next to management's candidates on the company's proxy materials that are mailed to shareholders each year before the annual meeting. Section 971 clarifies the SEC's authority to issue rules permitting the use by a shareholder of proxy solicitation materials supplied by an issuer of securities for the purpose of nominating individuals to membership on the board of directors of the issuer, under such terms and conditions as the Commission determines are in the interests of shareholders and for the protection of investors.

On August 25, 2010, the SEC adopted a final rule allowing holders of 3% of a company's stock who have held the shares for three years to place a nominee for director in the company's proxy materials.[6]

Disclosures Regarding Chairman and CEO Structures

Section 972 requires companies to disclose in their annual proxy report the reasons why the issuer has chosen the same person to serve as chairman of the board of directors and CEO or why the company has chosen to have different individuals fill those two positions.

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[6] Securities and Exchange Commission, "FACILITATING SHAREHOLDER DIRECTOR NOMINATIONS," Final Rule: Release Nos. 33-9136; 34-62764; IC-29384; File No. S7-10-09, August 25, 2010.

Subtitle H: Municipal Securities

The financial crisis raised a number of concerns about municipal securities markets. A number of towns and counties were sold complex derivatives contracts that proved very costly, and concerns persisted about "pay-to-play" abuses by politically connected intermediaries. Subtitle H makes a number of significant changes to the regulation of municipal markets.

Regulation of Municipal Advisors

Section 975 creates a new class of registrants under federal securities law. "Municipal advisors" are defined as persons who are not employees of a municipal entity but who provide advice to a municipal entity with respect to municipal financial products or the issuance of municipal securities, including advice relating to the structure, timing, and terms of securities offerings, or who undertake solicitations of a municipal entity. Municipal advisors include financial advisors, guaranteed investment contract brokers, third-party marketers, placement agents, solicitors, finders, and swap advisors, but do *not* include broker-dealers or municipal securities dealers serving as an underwriter (as defined in section 2(a)(11) of the Securities Act of 1933), SEC-registered investment advisers, or CFTC-registered commodity trading advisors. Municipal advisors must register with the Municipal Securities Rulemaking Board (MSRB), which is directed to make rules governing the business conduct of municipal advisors, and the SEC shall enforce those rules.

Majority of MSRB Members to be Independent

Section 975 also amends the composition of the Municipal Securities Rulemaking Board—the board will now have 15 members, eight of whom shall be public members, independent of the industry. That is, the majority of the board will consist of members not associated with any municipal securities broker, municipal securities dealer, or municipal advisor. The eight independent board members shall include at least one representative of investors in municipal securities, one representative of municipal entities, and at least one shall be a member of the public with knowledge of or experience in the municipal securities industry. The seven board members from the industry shall include representatives of bank and non-bank municipal securities dealers and at least one individual who is associated with a municipal advisor. Each member of the board shall be knowledgeable of matters related to the municipal securities markets.

GAO Studies

Sections 976 and 977 call for GAO to conduct (1) a study of the adequacy of disclosures made to investors in municipal securities, and (2) a broad review of the market, including an analysis of trading mechanisms; the needs of the markets and investors and the impact of recent innovations; recommendations for how to improve the transparency, efficiency, fairness, and liquidity of trading in the municipal securities markets; and potential uses of derivatives in the municipal securities markets.

GASB Funding

Section 978 establishes a source of funding for the Government Accounting Standards Board (GASB), which formulates accounting standards for the voluntary use of state and local governments. The section authorizes to SEC to require FINRA to collect reasonable accounting support fees from its members (who are broker-dealers and other securities professionals) and to remit such fees to the Financial Accounting Foundation (GASB's parent organization).

Office of Municipal Securities within the SEC

Responding to concerns that in recent years the SEC has devoted fewer resources to the oversight of municipal markets, Section 979 establishes the Office of Municipal Securities within the SEC. The Office shall be staffed sufficiently to carry out the requirements of this section, and must include individuals with knowledge of and expertise in municipal finance.

Subtitle I: Public Company Accounting Oversight Board, Portfolio Margining, and Other Matters

Subtitle I contains 19 sections dealing with a range of different topics.

PCAOB and Foreign Auditor Oversight Authorities

Section 981 deals with the authority of the Public Company Accounting Oversight Board (PCAOB) to exchange information with foreign regulatory bodies. If the PCAOB determines that it is appropriate and necessary to protect investors, it may share confidential and privileged information gathered in the course of its oversight of U.S. auditing firms with a foreign auditor oversight authority, provided that the foreign agency supplies (1) such assurances of confidentiality as the PCAOB may request; (2) a description of the applicable information systems and controls of the foreign auditor oversight authority; and (3) a description of the laws and regulations of the foreign government of the foreign auditor oversight authority that are relevant to information access.

PCAOB Authority Over Auditors of Broker-Dealers

Section 982 requires that all auditors of registered broker-dealers be regulated and examined by the PCAOB, whether or not the broker-dealer is a public company. (In general, PCAOB oversees only auditors of publicly traded firms.) This provision is related to the Madoff Ponzi scheme case—Madoff's broker-dealer was audited by an unregulated accounting firm with only two employees.

Portfolio Margining in SIPC Accounts

Section 983 amends the Securities Investor Protection Act of 1970 (SIPA), which protects customers from certain losses caused by the insolvency of their broker-dealer. Customers of failed broker-dealers may be reimbursed up to $500,000. Under previous law, the protections of SIPA did not extend to futures contracts (other than security futures). As a result, customers who used futures to hedge against drops in securities prices were not afforded SPIA protection across their entire portfolio.

Section 983 will enable customers to include both securities and related futures products in a single "portfolio margining account." SIPA protection will be based upon the net risk of the positions in the account.

Material Loan Loss Reviews

When insured depository institutions fail, and there is a material loss to the FDIC's deposit insurance fund, the Inspector General of the primary federal regulator of the failed institution is required to review the agency's supervision of the failed institution, including the agency's implementation of Prompt Corrective Action; ascertain why the institution's problems resulted in a material loss to the deposit insurance fund; and make recommendations for preventing any such loss in the future.

Before Dodd-Frank, the threshold for a material loan loss review was a loss of $25 million. Section 987 raises the threshold of "material loss" to $200 million for losses that occur in 2010 and 2011, to $150 million for losses in 2012 and 2013, and $50 million thereafter. The purpose of this section is to eliminate duplicative and repetitive reviews of many bank failures experienced in the crisis that are generally attributable to the same causes.

In addition, Section 987 directs the Inspectors General to prepare a semi-annual report on nonmaterial losses to determine if there were cases with unusual features that might justify a full loan loss review even though the materiality threshold was not reached. Those reports shall be made available upon request to any member of Congress.

Senior Investor Protections

Section 989A directs the Bureau of Consumer Financial Protection to establish a program to provide grants of up to $500,000 per fiscal year to individual states to investigate and prosecute misleading and fraudulent marketing practices or to develop educational materials and training to reduce misleading and fraudulent marketing of financial products toward seniors. States may use the grants for staff, technology, equipment, training and educational materials. To receive these grants, states must adopt rules on the use of designations in the offer or sale of securities, insurance products, or investment advice; on fiduciary or suitability requirements in the sale of securities; and on the sale of annuity products by insurers. The section authorizes $8 million to be appropriated for these purposes for fiscal years 2011 through 2015.

Inspector General Provisions

Section 989B amends Section 8G of the Inspector General Act of 1978 to clarify the delegation of authority to the Inspectors General of the Federal Labor Relations Authority, the National Archives and Records Administration, the National Credit Union Administration, the National Endowment for the Arts, the National Endowment for the Humanities and the Peace Corps.

Section 989C provides for a more transparent peer review process among federal inspectors general to increase accountability.

Section 989D provides that, in federal agencies for which a board or commission is the head of the entity, an inspector general may be removed only with the written concurrence of two-thirds of the board or commission.

Section 989E establishes a Council of Inspectors General on Financial Oversight, made up of the inspectors general of the banking agencies, the SEC, the CFTC, the Departments of Treasury and HUD, and the FHFA. The Council shall meet quarterly to discuss the ongoing work of each inspector general, with a focus on concerns that may apply to the broader financial sector and ways to improve financial oversight.

Section 989H requires the Chairmen of the Federal Reserve, the CFTC, the SEC, the NCUA, and the Director of the Pension Benefit Guaranty Corporation (PBGC) to take action to address deficiencies identified by a report or investigation of the Inspector General of the establishment concerned, or to certify to Congress that no action is necessary or appropriate in connection with such deficiency.

Exemption from Section 404(b) of the Sarbanes-Oxley Act

Section 989G provides an exemption from Section 404(b) of the Sarbanes-Oxley Act for public companies with a market capitalization of less than $75 million. Section 404(b) requires that a company's internal accounting controls be audited by the firm's outside accountant.[7] Section 404(a), which requires management to certify its responsibility for establishing and maintaining adequate internal controls, remains in force for all public companies.

In addition, the SEC is directed to study and report to Congress on the effect of extending the 404(b) exemption to companies with market capitalization below $250 million. Section 989I directs the GAO to study the impact of Section 989G, in terms of number of accounting restatements, cost of capital, investor confidence, and voluntary compliance.

Regulation of Fixed Index Annuities

Section 989J states that certain insurance or endowment policy or annuity contracts, the values of which do not vary according to the performance of a separate account, shall be treated as exempt securities under the Securities Act of 1933. This means that the sale of such contracts will be regulated by state insurance commissions rather than by the SEC. The exemption will only apply in states that adopt suitability or fiduciary standards that meet or exceed model codes developed by the National Association of Insurance Commissioners (NAIC).

Subtitle J: SEC Funding

Subtitle J changes the way the SEC is funded. Since its creation in the 1930s, the SEC has collected fees on a variety of securities market transactions. Usually, the amount of such fee collections has exceeded the SEC's budget. Since 2000, the excess has gone not to the Treasury general fund, but rather to a special account available only to appropriators to fund the SEC. Under Dodd-Frank, one of the two major fees (a percentage of the proceeds from all sales of corporate stock) will be adjusted periodically so that the amount collected is approximately equal to the SEC's annual appropriation. The other major fee (a percentage of the value of all new securities registered for public sale) will go to the Treasury general fund. Target collection amounts are set out through FY2020.

Subtitle J establishes a Reserve Fund in the SEC which may hold up to $100 million in excess fee collections. The Fund may be used to achieve flexibility and continuity in spending, in order that delays in enacting appropriations bills do not impede multi-year spending projects.

In addition, the law provides for the SEC to submit its budget request directly to Congress, rather than through the Office of Management and Budget. Appropriations for the SEC are authorized through FY2015, when the amount will be $2.25 billion, about double the SEC's 2010 budget.

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[7] See CRS Report RS22482, *Section 404 of the Sarbanes-Oxley Act of 2002 (Management Assessment of Internal Controls): Current Regulation and Congressional Concerns*, by Michael V. Seitzinger.

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